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UNCLAS SECTION 01 OF 05 TEGUCIGALPA 001745

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TAGS: EFIN ECON EAID ETRD ELAB PGOV HO
SUBJECT: Honduran Fiscal Policy: Academicians Present Tax Collection Reform Proposals; GOH Pledges Only Discipline

¶1. Summary. A recent seminar on the importance of tax reforms raised a number of interesting themes, but GOH officials present limited their remarks to exhortations for discipline and calls for increased tax revenue. Featured academic speakers said there must be improved tax collection, a more efficient and transparent tax authority, and sustainable debt levels overall. One speaker made the case for scrapping the entire current income tax system in favor of a flat tax. The World Bank speaker pointed to the need to always remember the purpose behind the taxation, urging officials to look at quality spending as the driver of tax policy. The closing speaker reminded attendees that, as elegant as any economic theory might be, implementation is a messy political business and results will often fall short of the mark. End Summary.

¶2. On August 18, the Honduran NGO Foundation for Investment and Export Development (FIDE), with support from USAID, sponsored a one-day workshop on fiscal policy focusing on tax collection. In addition to featured academicians, the program included interventions by the Minister of Finance, William Chong Wong, the Director of Public Credit Orlando Garner, and World Bank Senior Economist Dante Mossi. Sessions focused on the importance of tax collection to development, the role of the tax authorities, sustainability of public debt, and lessons learned from the Guatemalan "fiscal pact" experience.

Minister of Finance: Cracking the Whip

¶3. Speaking for less than ten minutes, Minister of Finance William Chong Wong used the occasion to deliver a fiscal tough-love message. The GOH must maintain fiscal discipline, he said. Debt forgiveness is a wonderful thing, but it cannot be used as a justification to lower taxes. Similarly, CAFTA is a great opportunity for Honduras, but a way must be found to make up for the revenue losses from cutting customs duties, which he estimated at 750 million Lempiras (about 40 million USD) over the next 5 years. Finally, he said, Foreign Direct Investment is an important source of economic growth, but foreign firms must pay their fair share of taxes. Chong said he is seeking double taxation agreements with the U.S. and other countries, to ensure that firms pay their taxes in Honduras and receive tax credits in their home country. He also wants greater data sharing with trade partners, to minimize the use of transfer pricing schemes to evade taxes.

VAT Taxes for Revenue; Social Spending for Progressivity

¶4. In an information-rich and rapid-fire presentation, Interamerican Development Bank (IDB) Senior Economist Alberto Barreix focused on why tax reform is needed in Central America. First, he said, the growing interconnectedness of economies has removed most freedom of choice regarding commercial, monetary, and exchange rate policies, leaving only fiscal policy as an economic lever for national governments. Second, there is a growing recognition that certain investments -- particularly in education -- must be made even in the poorest countries, if they are to compete effectively in the future. If we do not grasp this chance, Barreix said, "we will have to answer to the future generations for the lost opportunities."

¶5. Barreix then listed five specific reasons why tax reform is urgent in Central America: (1) to fund improvements in social infrastructure and competitiveness; (2) to reach fiscal sustainability in highly-indebted countries; (3) to identify and implement substitutes for forgone revenues from tariff cuts under CAFTA; (4) to improve revenue collection by phasing out income tax exemptions in freeports (maquilas); and (5) to promote regional coordination in tax policies to prevent a "race to the bottom." Tax theory says

taxes must be equitable, efficient, and simple, he said; now we must add to that list that taxes should be easy to coordinate across borders.

¶6. Drawing from his own forthcoming book, Barriex cited a positive evolution of tax collection in the region:

Tax revenues as a percentage of GDP:

	1990	1995	2000	2003
CR	10.8	11.4	11.9	13.0
ES	7.6	11.9	11.0	12.6
GT	6.9	8.0	9.5	10.3
HO	15.0	17.3	16.6	15.9
NI	8.1	12.2	14.5	15.8
AVG	9.7	12.2	12.7	13.5

While the rest of the region continues to improve in tax collections, Honduras runs against the trend, actually seeing a decline in tax revenues as a percentage of GDP over the last decade. This could be due in part to tax evasion, but also to the web of tax exemptions and incentives created to attract investment, particularly in the maquila (light assembly) sector. Tax incentives have been provided to the majority of manufacturing and assembly firms (operating in free trade zones of several types) and companies in the tourism, mining, and energy fields, providing these companies with exemptions from customs duties, sales tax, and income tax. As Post reported previously, Honduras collects (using official measures) taxes equivalent to 16 percent of GDP. Assuming GDP in Honduras is underestimated by 35 percent, this tax receipt measure falls to 12 percent of GDP using the appropriate estimate of GDP. The World Bank advises that this percentage is only half of that which is considered healthy for a developing country. This level of tax collection is not adequate to fund the key government services and investments that are needed.

¶7. Clearly, Central American countries must collect more taxes to better fund social obligations, Barriex said. However, the relatively young populations in these countries mean a lower social security bill, softening the blow somewhat and providing time to improve collections. According to Barriex, the fiscal situation looks like this (all figures in percentage of GDP as of 2003):

	Total Income	Debt Service	Social Security	Available Income
CR	22.3	4.3	4.4	13.6
ES	12.6	2.0	1.3	9.3
GT	10.0	1.0	0.3	8.7
HO	16.9	2.0	0.9	14.0
NI	17.8	3.8	1.8	12.2
AVG	17.1	2.7	2.9	11.6
OECD	37.4	1.6	12.2	23.6

¶8. On the topic of value-added taxes (IVA, in Spanish) Barriex advocated improved tax design and improved collection through IVAs, since they avoid "tax cascades" (where taxes are being paid on previous taxes) and facilitate competition with the region. He suggested harmonizing tax bases within the region, while allowing competition and fiscal flexibility in the rates. He agreed that the IVA is a regressive tax, noting that "an IVA is not a redistributive tax; it is a tax for collections." To counteract the regressive attributes of an IVA, he recommended targeted social spending for the poor, and increased application of personal income taxes. Finally, he agreed with Minister Chong that as regional integration moves forward, data sharing among countries must be improved to minimize tax evasion through transfer pricing schemes.

World Bank Responds: Quality, Not Just Quantity
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¶9. Dante Mossi, Senior Economist with the World Bank, responded to these points, noting that the choice of the level of tax revenue collections is a sovereign one and dependent on the quality of social services the State wants to deliver. The quality of that spending is a key factor, as is the political choice of allocation (for example, whether to allocate a certain quantity of funds to educate one university student or six elementary students). Finally, the quality of tax collections is important -- that is, who is paying the tax burden? What is the overall impact on the poor? A 2002 IDB report entitled "Honduras: Toward a More Transparent and Diversified Tax System" noted that the current Honduran tax structure is highly regressive, since most of the tax exemptions are provided to the wealthy. According to the report, the poorest Hondurans pay a percentage of their income in taxes that is 75 percent higher than the average taxpayer, whereas the richest Hondurans pay a percentage of their income in taxes that is 20 percent lower than average.

Tax Administration Design

¶10. While not addressing Honduras specifically, Dr. Erick Thompson of the University of International Cooperation (UCI) in Costa Rica identified the key elements in creating a modern tax authority (TA). The TA should induce large-scale compliance, based on the fear felt by evaders of detection and sanction. This fear of getting caught should be amplified by self-policing in the private sector, which should see tax evasion by a competitor as unfair competition and work with the TA to identify and minimize such fraud. In carrying out these tasks, the TA's twin emphases should be customer service to contributors and revenue controls.

¶11. After a lengthy discussion of the need for and proper design of quality-assurance indictors for TAs, Thompson turned to his recommendations for Central America. His key recommendation was that rather than attempt to establish a single, regional customs service, which would suffer from questions of composition and financing, Central America should strive for a European Union-style system, where each national service is preserved, but policy is harmonized. Enforcement must be implemented at the local level, he said, but policy must be centrally set and enforced to prevent differing enforcement regimes in the field. Asked what would be the duties of a Central American customs service in the wake of CAFTA reducing most duties to zero, Thompson pointed to two key additional responsibilities that would also contribute to revenue collection: First, Customs would be responsible for administering the levying of IVA on imports. Second, Customs should integrate closely with internal tax authorities to facilitate integrated taxpayer audits by cross checking tax receipts with import records.

Debt Sustainability: How Much Is Too Much?

¶12. Dr. Oswald Cespedes of the Assessment Commission on High Technology (CAATEC) of Costa Rica presented the results of a financial analysis seeking to evaluate debt sustainability and compare it to the recently proposed measure of the Natural Debt Limit (NDL). For methodological reasons, the NDL theorem could not be applied to Honduras, but Cespedes nevertheless hazarded a number of recommendations. The Honduran ratio of public debt to GDP (currently 75.5 percent) "is on track to improve over the medium term, despite currently being considered unsustainable. It is foreseen that this ratio will fall to 61 percent by 2010, principally due to the debt forgiveness resulting from the attainment of the HIPC Completion Point in April 2005." (Note: He bases this prediction on an estimated debt service reduction of $120 million per year. The GOH estimates the actual debt service savings under HIPC at $212 million per year, which would imply a substantially lower debt/GDP ratio in 2010 than that predicted here. End Note.) He concluded by saying that while counter-cyclical fiscal policies would be desirable, the current low ratios of revenues/GDP do not permit adequate countercyclical operations.

Laffer Strikes Back: The Case for a Flat Tax

¶13. Dr. Daniel Wisecarver, Director of the Graduate School of Economics and Business (ESEN) in El Salvador, spoke on the need for reforming income taxes in Central America. In each of the five countries of the region, income taxes represent about one-quarter of total tax revenues, or about three to four percent of GDP. A government cannot be very progressive, Wisecarver said, with collection rates so low. Unfortunately, there is no culture of trust in these countries, or any indication that the governments have the political will to reform the current income tax system.

¶14. The solution, he said is to scrap the whole system. Scrap the income tax; scrap the exemptions. Instead, he said, turning to the Laffer curve for support, Central American states should move to a flat tax on income. A simplified system with lower tax rates would improve collections rates and total revenue, Wisecarver said, pointing to Russia and Estonia as examples. Because there would be no exemptions, and the taxes would be based on income alone, it would be horizontally equitable. To ensure progressivity, he suggests a large, universal exemption, and proposes the level of that exemption be set at the median income level for the country. That would ensure that right from the start half of the population is entirely exempt, reducing political opposition to the plan, while also ensuring vertical equity by obliging the rich to pay their share. The plan would succeed, Wisecarver said, because the new tax would be simple, neutral, and progressive.

Director of Public Credit Sticks to the Script
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¶15. Keeping his remarks short and on-message, Ministry of Finance Director of Public Credit Orlando Garner laid out GOH priorities without commenting directly on the proposal floated during the sessions. Echoing his Minister's earlier remarks, Garner said that if Honduras is to benefit from the recent debt reduction, it must maintain fiscal discipline. GOH policies must be sustainable, and any external financing must be on concessional terms. The problem, he said, is that as Honduras grows its access to concessional financing declines. Making matters worse, concessional financing (such as IDA subscriptions) is drying up globally. Nevertheless, the GOH -- including whatever party is elected in the upcoming November 27 elections -- must limit its use of borrowing according to the ability of the country to pay. Garner admitted that regional harmonization of tax policies will be a challenge; but, he said, recent events offer Honduras many opportunities, and Honduras must find a way to take advantage of them.

Fiscal Pacts: Great Idea; Shame They Don't Work
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¶16. The final speaker of the day, Dr. Hugo Maul of the National Center for Economic Research (CIEN) of Guatemala, outlined the nature and challenges of the much-touted "fiscal pact." A fiscal pact is "a national agreement on the amount, origin, and use of State resources in carrying out its designated functions." It comprises several elements: a fiscal balance requirement (no spending beyond earnings); sufficient government revenues to carry out government activities; efficient and transparent tax administration; prioritized spending; controls on public debt (not to be used as a substitute for revenue); responsible management of public goods; accountability and social auditing; and fiscal decentralization.

¶17. Unfortunately, Maul said, in the case of Guatemala the pact has failed. After tracing the causes of this failure, Maul extracted the following lessons-learned from the experience. First, agreeing to a plan and carrying it out are two very different things. If goals are not met, who is responsible, and what measures are there to require compliance? Second, an agreement that tries to accomplish everything ends up accomplishing nothing. Third, levying taxes is a sovereign exercise, and one unlikely to happen if consensus is required. (Or, as he pointed out, there's a reason they are called "impuestos" -- making a pun with the Spanish word, which can be translated as either "taxes" or "that which is imposed.") Fourth, the legislature is the elected representative of the people, and that responsibility cannot be arrogated by other groups. By what authority does an NGO claim the right to veto a Congressional act? Finally, a pact that imposes burdens on any part of society, yet requires consensus, is doomed to fail, as special interests will either refuse to approve or refuse to comply. At the end of the day, Maul, said, economists must remember that no matter how beautiful or well-proven the theory, the practice is always a political decision, taken by politicians. Designing a perfect pact is not the same as implementing one.

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